REPORT OF EXAMINATION
OF THE

VALLEY INSURANCE COMPANY

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed April 21, 2008

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Los Angeles, California
February 15, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

VALLEY INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 12790 Merit Drive, Dallas, Texas 75251. The Company's statutory home office is located at 818 West 7th Street, Los Angeles, California 90017.

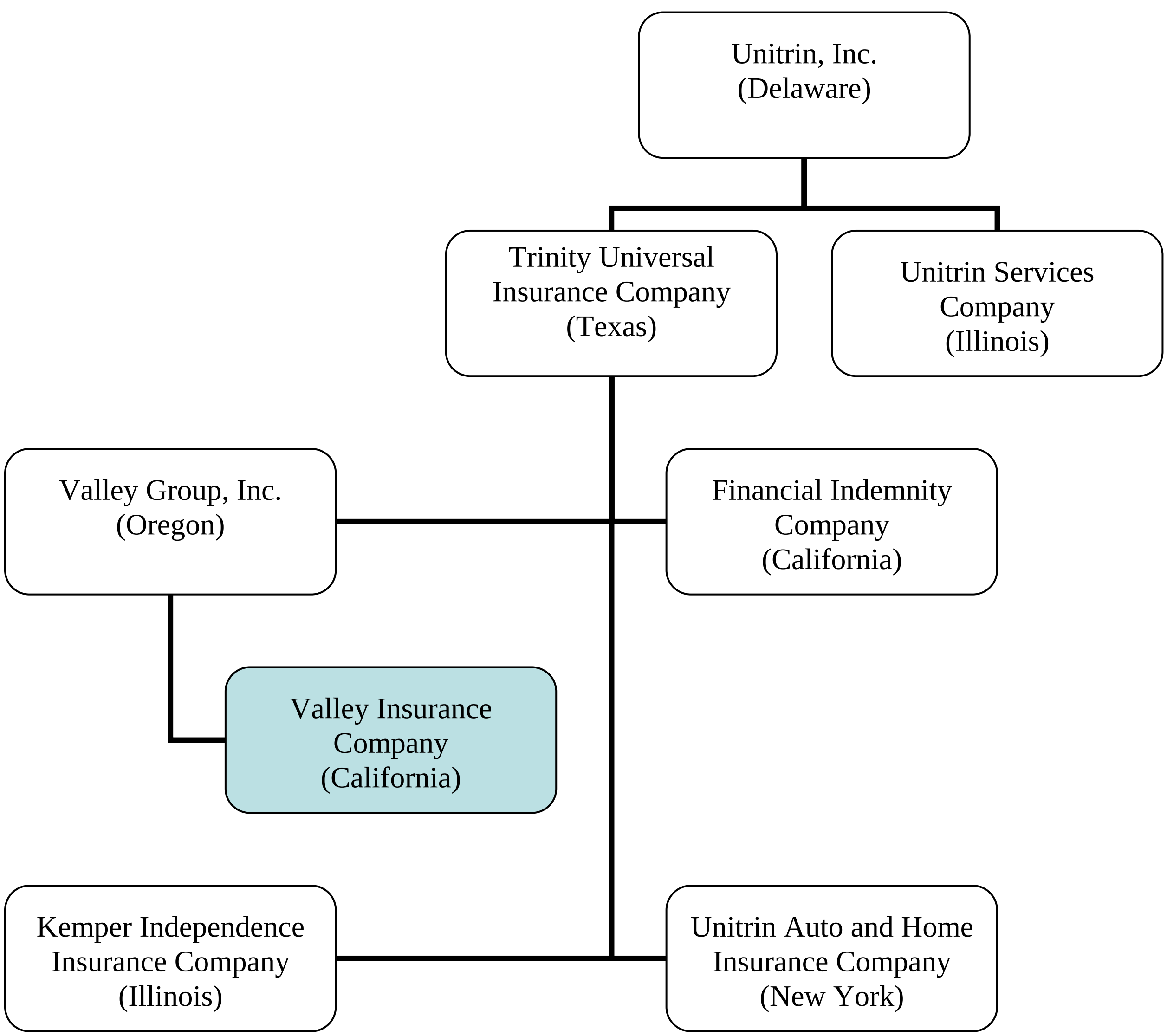
SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system (all ownership is 100%):



Management of the Company is vested in a seven-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2006 follows:

Directors

Name and Residence	Principal Business Affiliation
David Frederick Bengston Bull Valley, Illinois	Vice President Unitrin, Inc.
Eric John Draut Arlington Heights, Illinois	Executive Vice President, Chief Financial Officer and Director Unitrin, Inc.
Samuel Lewis Fitzpatrick Burr Ridge, Illinois	Secretary Trinity Universal Insurance Company
Edward James Konar St. Charles, Illinois	Vice President Unitrin, Inc.
Jack Daniel Lubner McKinney, Texas	Vice President and Director Trinity Universal Insurance Company
James Allen Schulte Jacksonville, Florida	President and Director Trinity Universal Insurance Company
Donald Gene Southwell Wayne, Illinois	President, Chief Executive Officer and Director Unitrin, Inc.

Principal Officers

Name	Title
Jack Daniel Lubner	President
Dorothy Ann Langley	Secretary
Clark Hubbard Roberts	Treasurer

Management Agreements

Administrative Services Agreement: The Company entered into an Administrative Services Agreement, effective January 1, 2000, with Trinity Universal Insurance Company (Trinity). Under the terms of the agreement, Trinity provides the Company with all administrative services, including but not limited to, underwriting, marketing, reinsurance, claims related, and other services, such as maintenance of records and documents, data processing and accounting, and regulatory compliance. The Company also authorized Trinity to deposit all funds collected on the Company's behalf into a Trinity account maintained in a fiduciary capacity. The Company reimburses Trinity 100% of its actual expenses. This agreement was approved by the California Department of Insurance (CDI) on December 14, 1999.

Administrative Services Agreement: The Company entered into an Administrative Services Agreement, effective January 1, 2002, with Trinity and its affiliates for providing certain services by the Company's personnel based in Oregon. Under the terms of the agreement, the Company provides underwriting, marketing, reinsurance, claims related and other services, such as maintenance of records and documents, data processing and accounting, and regulatory compliance. The Company also collects all funds on behalf of the affiliates. In return, the Company is reimbursed 100% of the actual expenses incurred. The agreement was approved by CDI on December 24, 2001.

During the course of current examination, it was noted that the Company did not bill its parent and the affiliates for services provided. However, the Company was reimbursed by Trinity for these services in accordance to a previously executed intercompany Quota-Share Reinsurance Agreement between the Company and Trinity. It is recommended that the Company comply with the terms and provisions of the Administrative Services Agreement with Trinity and its affiliates for providing certain services by the Company's personnel based in Oregon.

General Service Agreement: The Company entered into a General Service Agreement with Trinity, effective December 14, 1999. Under the terms of the agreement, Trinity provides the Company with certain services, such as executive management, financial accounting and reporting, purchasing and accounts payable, tax return preparation, maintenance of benefit plans, benefit plan regulatory reporting and support, cash management and bank relations, financial planning and analysis of results of operations, capital project review and evaluation, real estate management, legal support and advice, marketing service support, actuarial services, loss control services and information system support and advice. In return, the Company pays Trinity the actual expenses incurred by Trinity employees that provide the services. This agreement was approved by the CDI on November 19, 1999.

General Service Agreement: The Company entered into a General Service Agreement with Unitrin Services Company (USC), an Illinois corporation and the Company's affiliate, effective July 1, 2004. Under the terms of the agreement, USC provides the Company with certain services, such as trade execution and investment analysis, financial accounting and reporting, purchasing and accounts payable, investment accounting, tax return preparation, tax accounting and tax advice, maintenance of benefit plans, administration of post-retirement medical benefits (if applicable), benefit plan regulatory reporting and support, risk management, automobile fleet management, internal audit, cash management and bank relations, financial planning and analysis of results of operations, capital project review and evaluation, real estate management, corporate secretarial functions, and legal support and advice. In return, the Company pays USC for the services provided based on the premiums plus net investment income of the Company as a percentage of total premiums of all affiliates of USC or hourly rate depending on different kinds of service. This agreement replaced the General Service Agreement between the Company and USC entered on September 30, 1999. This agreement was approved by the CDI on June 16, 2004.

General Service Agreement: The Company entered into two separate General Service Agreements with its affiliates Kemper Independence Insurance Company (KIIC) and Unitrin Auto and Home Insurance Company (UAH), respectively, both effective January 1, 2005. Under the terms of the agreements, KIIC and UAH provides the Company with certain services, such as marketing, underwriting, claims related, and facilities, supplies and staffing. Expenses incurred by KIIC and UAH shall be allocated on a fair and reasonable basis. The agreement with KIIC and UAH was approved by the CDI on December 29, 2004 and December 23, 2004, respectively.

Computer Services Agreement: The Company entered into a Computer Services Agreement with USC, effective July 1, 2004. Under the terms of the agreement, USC provides the Company with computer data processing services using computer systems maintained by USC. USC also provides certain consulting services, including purchase, implementation and maintenance of hardware and software. The Company is charged for its proportionate share of the cost of maintaining and operating the system based on the Company's actual use. Acquisitions made on behalf of the Company by USC are charged to the Company on the basis of the entire cost of the acquisition. This agreement replaced the Computer Services Agreement between the Company and USC entered on September 30, 1999. This agreement was approved by the CDI on June 16, 2004.

Federal Income Tax Agreement: The Company and its affiliates entered into a Federal Income Tax Agreement with Unitrin, Inc. (Unitrin), the Company's ultimate parent. The agreement establishes the method of settlement of federal income tax payments and refunds among the Company, Unitrin and other affiliates named in the agreement. The agreement provides that the Company and other affiliates are included in Unitrin's consolidated tax return for federal income tax purposes. Under this agreement, the Company pays Unitrin the amount of tax it would pay or refund had it filed on a stand alone basis. This agreement was approved by the CDI on December 3, 1999.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2006, the Company was licensed to transact multiple lines of property and casualty insurance. The following is a listing of the states in which the Company is licensed:

Arizona	Nevada
California	Oklahoma
Colorado	Oregon
Idaho	Texas
Kansas	Utah
Maine	Washington
Montana	Wyoming

The Company offers a range of personal and commercial insurance products including automobile, homeowners, commercial multi-peril, fire, casualty, and other property and casualty insurance to individuals and businesses. Business is written through three business segments, which are Kemper Auto and Home (KAH), Unitrin Business Insurance (UBI) and Unitrin Specialty Line (USL). KAH writes personal lines, UBI writes commercial lines and USL writes specialty lines, including non-standard personal and commercial auto. The Company's products are marketed primarily in the western United States by independent agents. The direct premium is written in the states of California, $11.9 million (53.0%); Oklahoma, $5.4 million (24.1%); Nevada, $1.9 million (8.2%); Utah, $1.7 million (7.8%); Idaho, $1.5 million (6.8%); and Oregon, $24,795 (0.1%).

REINSURANCE

Assumed

The Company assumed a small book of business through its participation in a mandatory pool with the Auto Insurance Plan Service Office (AIPSO). AIPSO is a non-profit organization, which provides administration services to the automobile insurance residual market.

Ceded

The reinsurance programs are arranged by each business segment at the segment level and cover all legal entities writing the line of business for that segment.

The largest net amount retained by the Company, among all segments, is $2 million on any one risk for property and casualty lines. The following is a summary of the principal ceded reinsurance treaties in force as of December 31, 2006:

Kemper Auto and Home Segment:

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits
Excess of Loss			

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits
1st Layer Excess of Loss – Property	Various/Authorized and Unauthorized	$1 million per risk	$1 million excess of $1 million, not to exceed $2 million / occurrence
2nd Layer Excess of Loss – Property	Various/Authorized and Unauthorized	None	$3 million excess of $2 million, not to exceed $3 million / occurrence
3rd Layer Excess of Loss - Property	Various/Authorized and Unauthorized	None	$5 million excess of $5 million, not to exceed $5 million / occurrence
1st Layer Excess of Loss – Casualty	Various/Authorized and Unauthorized	$1.25 million	$750,000 excess of $1.25 million / occurrence
2nd Layer Excess of Loss – Casualty	Various/Authorized and Unauthorized	None	$4 million excess of $2 million /occurrence
3rd Layer Clash Excess of Loss - Casualty	Various/Authorized and Unauthorized	None	$15 million excess of $6 million / occurrence
1st Layer Excess of Loss - Catastrophe	Various/Authorized and Unauthorized	$40 million + 35.25% of $30 million excess of $40 million	64.75% of $30 million excess of $40 million / occurrence
2nd Layer Excess of Loss - Catastrophe	Various/Authorized and Unauthorized	12.225% of $80 million excess of $70 million	87.775% of $80 million excess of $70 million /occurrence
3rd Layer Excess of Loss - Catastrophe	Various/Authorized and Unauthorized	19.75% of $100 million excess of $150 million	80.25% of $100 million excess of $150 million /occurrence
Other Property/Casualty Reinsurance Treaties			
Quota Share	Trinity Universal Insurance Company	10 % after 3rd parties reinsurance	90% after 3rd parties reinsurance

Unitrin Specialty Line Segment:

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits
Casualty Excess of Loss			
1st Clash Excess of Loss	Various/Authorized and Unauthorized	$1 million / occurrence	$4 million excess of $1 million / occurrence
2nd Clash Excess of Loss	Various/Authorized and Unauthorized	$5 million / occurrence	$20 million excess of $5 million / occurrence
Property Excess of Loss - Catastrophe			
1st Layer Excess of Loss	Various/Authorized and Unauthorized	$4 million / occurrence	$6 million excess of $4 million / occurrence
2nd Layer Excess of Loss	Various/Authorized and Unauthorized	None	$10 million excess of $10 million / occurrence
3rd Layer Excess of Loss	Various/Authorized and Unauthorized	None	$20 million excess of $20 million / occurrence
Other Property/Casualty Reinsurance Treaties			
Quota Share	Trinity Universal Insurance Company	10% after 3rd parties reinsurance	90% after 3rd parties reinsurance

Unitrin Business Insurance Segment:

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits
Excess of Loss			
1st Excess of Loss – Property	General Reinsurance Corporation	$2 million	$3 million excess of $2 million, not to exceed up to $9 million / occurrence.
2nd Clash Excess of Loss – Property	Various/Authorized and Unauthorized	$5 million	$20 million excess of $5 million / occurrence
Excess of Loss – Workers' Compensation	Various/Authorized and Unauthorized	$5 million	$30 million excess of $5 million / occurrence
1st Layer Excess of Loss – Catastrophe	Various/Authorized and Unauthorized	$4 million	$6 million excess of $4 million / occurrence
2nd Layer Excess of Loss – Catastrophe	Various/Authorized and Unauthorized	None	$10 million excess of $10 million / occurrence
3rd Layer Excess of Loss –	Various/Authorized and	None	$20 million excess of $20

Type of Contracts	Reinsurer(s) Name	Segment Retention	Reinsurer's Maximum Limits
Catastrophe	Unauthorized		million / occurrence
Other Property/Casualty Reinsurance Treaties			
Quota Share / Excess of Loss	General Reinsurance Corporation	25% of first $5 million	75% of the first $ 5 million plus the differences, up to $10 million in aggregate
Property Facultative	General Reinsurance Corporation	$5 million / risk	$10 million / risk
Quota Share	Trinity Universal Insurance Company	10% after 3rd parties reinsurance	90% after 3rd parties reinsurance

The Company also participates in the Quota-Share Reinsurance Agreement with its parent, Trinity Universal Insurance Company (Trinity), effective April 1, 2005. Under the term of the reinsurance agreement, the Company cedes 90% of its total written premium to Trinity and, in return, Trinity assumes 90% of the net liability beyond all third party facultative or treaty reinsurance. The agreement was approved by the California Department of Insurance (CDI) on February 23, 2005. The total reinsurance recoverable from Trinity was $61.8 million, which was 98% of the total reinsurance recoverable from all reinsurers as of December 31, 2006. The Company reported total ceded premium and reinsurance recoverable of $20.3 million and $63.2 million, respectively, as of December 31, 2006.

ACCOUNTS AND RECORDS

Commingling of Assets

During the course of the examination, it was noted that the majority of premiums written (and related receipts) by the Company and affiliates are remitted directly to an account maintained by the Company's parent, Trinity Universal Insurance Company (Trinity), in a fiduciary capacity. Under an Administration Services Agreement, Trinity collects all premiums and deposits these premiums into a Trinity account in the State of Texas. Trinity allocates the cash receipts to the proper affiliate and settles along with other loss payment, reinsurance recoverable, and other intercompany services fees on a monthly basis. However, the deposit of the Company's premiums into a Trinity account outside the State of California is not in compliance with the California Insurance Code (CIC) Sections 1100 and 1104.1. CIC Section 1100 requires all investments and deposits of the assets of an insurer, all purchases on behalf of an insurer, and all sales made of the property and effects of an insurer shall be made in its own name, or in that of a corporation authorized to act as a trustee under California laws. CIC Section 1104.1 requires that the Company's asset be deposited in an approved California custodial account. It is noted that the Company did not comply with same recommendation recorded in the prior examination report as of December 31, 2003. It is recommended that the Company comply with CIC Sections 1100 and 1104.1.

Related Party Settlements

The Company's business is written through three business segments and inter-company receivables and payables are settled at the segment level on a monthly basis. Total expenses accrued by each business segment are settled on a monthly basis with Unitrin, the ultimate parent. The expenses include all affiliated and unaffiliated reinsurance recoverable and payables, premium receipts, loss payments, and management service fees. Each segment then allocates total management service fees to each insurer based on the amount of premiums written by each insurer. The Company was unable to provide the breakdown of management service fees due to the way records are maintained. It is recommended that the Company maintain adequate documentation to support financial statement accounts. The documentation should be prepared in sufficient detail as to allow for a full and complete audit trail from the Annual Statement to individual records.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 15,713,553	$	$ 15,713,553	
Properties held for the production of income	7,108,253		7,108,253	
Cash and short-term investments	2,346,298		2,346,298	
Investment income due and accrued	236,995		236,995	
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	1,430,208	35,112	1,395,096	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	3,970,934		3,970,934	
Amounts recoverable from reinsurers	767,255		767,255	
Net deferred tax asset	11,832,467	11,832,467		
Guaranty funds receivable or on deposit	7,085		7,085	
Aggregate write-ins for other than invested assets	9,889	9,222	667	
Total assets	$ 43,422,937	$ 11,876,801	$ 31,546,136	

Liabilities, Surplus and Other Funds

Losses			$ 4,075,558	(1)
Reinsurance payable on paid losses and loss adjustment expenses			66,955	
Loss adjustment expenses			1,979,727	(1)
Other expenses			110,881	
Taxes, licenses and fees			50,062	
Unearned premiums			811,062	
Advance premiums			7,207	
Ceded reinsurance premiums payable (net of ceding commissions)			5,395,432	
Amounts withheld or retained by company for account of others			305	
Remittances and items not allocated			3,045	
Provision for reinsurance			244,872	
Payable to parent, subsidiaries and affiliates			759,735	
Aggregate write-ins for liabilities			644,970	
Total liabilities			14,149,811	
Common capital stock		$ 2,600,000		
Gross paid-in and contributed surplus		12,814,580		
Unassigned funds (surplus)		1,981,745		
Surplus as regards policyholders			17,396,325	
Total liabilities, surplus and other funds			$ 31,546,136	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income		
Premiums earned		$ 2,505,532
Deductions:		
Losses incurred	$ 589,766	
Loss expenses incurred	582,769	
Other underwriting expenses incurred	898,899	
Total underwriting deductions		2,071,434
Net underwriting gain		434,098
Investment Income		
Net investment income earned	$ 1,056,916	
Net realized capital gain	1,932,471	
Net investment gain		2,989,387
Other Income		
Net loss from agents' balances charged off	$ (26,337)	
Finance and service charges not included in premiums	30,104	
Total other income		3,767
Net income		$ 3,427,252

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		$ 13,904,641
Net income	$ 3,427,252	
Change in net unrealized capital gains or (losses)	(1,623)	
Change in net deferred income tax	(338,468)	
Change in non-admitted assets	316,825	
Change in provision for reinsurance	87,698	
Change in surplus as regards policyholders for the year		3,491,684
Surplus as regards policyholders, December 31, 2006		$ 17,396,325

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2006

Surplus as regards policyholders, December 31, 2003, per Examination			$ 11,604,055
	Gain in Surplus	Loss in Surplus	
Net income	$ 5,879,310	$	
Change in net unrealized capital losses		44,146	
Change in net deferred income tax	548,735		
Change in nonadmitted assets		471,558	
Change in provision for reinsurance		120,071	
Totals	$ 6,428,045	$ 635,775	
Net increase in surplus as regards policyholders for the examination			5,792,270
Surplus as regards policyholders, December 31, 2006, per Examination			$ 17,396,325

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance reviewed the Company's actuarial work papers with regards to losses and loss adjustment expense reserves. Based on the review, the Company's reserves as of December 31, 2006 for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control - Management Agreements - Administrative Services Agreement (Page 4): It is recommended that the Company comply with the terms and provisions of the Administrative Services Agreement with Trinity Universal Insurance Company and its affiliates for providing certain services by the Company's personnel based in Oregon.

Accounts and Records - Commingling of Assets (Page 10): It is noted that the Company did not comply with the same recommendation recorded in the prior examination report as of December 31, 2003. It is recommended that the Company comply with California Insurance Code Sections 1100 and 1104.1.

Accounts and Records - Related Party Settlements (Page 11): It is recommended that the Company maintain adequate documentation to support financial statement accounts.

Previous Report of Examination

Management and Control - Management Agreements - Administrative Services Agreement (Page 5): It was recommended that the Company formalize an agreement between the Company and Trinity Universal Insurance Company (Trinity) which establishes the compensation the Company receives for assigning its share of premium receivable to Trinity and, clarify that Trinity purchases the entire premiums receivable balance upon cession of the Company's premiums by the Company as per the Quota-Share Reinsurance Agreement. The Company has complied with this recommendation.

Accounts and Records - Commingling of Assets (Page 8): It was recommended that the Company and Trinity implement procedures, which account for collected premium receipts and establish proper procedures tracking collected premiums. The Company has not complied with this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and affiliates' employees during the course of this examination is hereby acknowledged.

Respectfully submitted,

/S/

Jack Ho, AES, CFE, CISA
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California